The Director of Central Intelligence

Washington, D.C. 20505

24 September 1985

The Honorable Leo Cherne
Vice Chairman
President's Foreign Intelligence
Advisory Board
340 Old Executive Office Building
Washington, D. C. 20500

Dear Leo,

Per our conversation this morning, enclosed are my Dallas speech and the Atlantic Monthly article.

Yours,

Bill

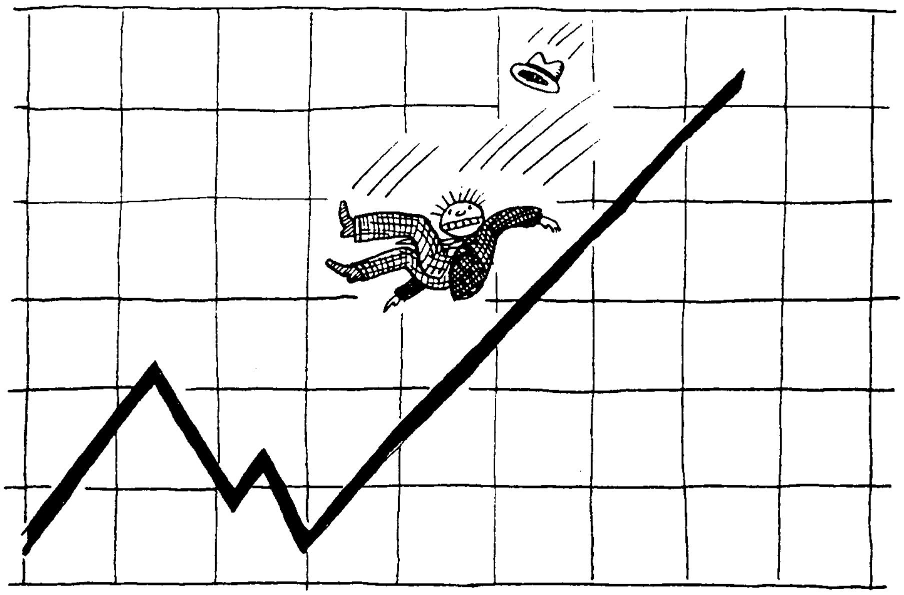
William J. Casey

Enclosures

innovation is to have made such extravagance banal—somehow bringing it within reach of all, even those who cannot really afford it. To the extent that funereal excess victimizes or impoverishes, Mitford and her ilk have a point. But archaeologists one day will also have a point if they infer from the evidence of our burial grounds that America in the mid-twentieth century experienced a prolonged period of garish but largely beneficent social change.

Yes, I am uncomfortable with the American Way of Death. Much of it is hideous, pretentious, and unprincipled. But the gaudy accouterments of death are signs of vitality and clues to later generations that our society was relatively egalitarian and robust. This, to my mind, is the message of the orbiting mausoleum. Alive or dead, it seems to say, in America you have a shot at upward mobility.

—*William Rathje*



WASHINGTON

THE THREE FISCAL CRISES

Unprecedented budget and trade deficits, combined with unprecedented borrowing from other nations, darken the nation's future

Economics does not easily accept the idea of irreversibility. In principle, almost no change is so permanent that it cannot be undone. If people are no longer eager to buy your goods and services, if your nation's comparative advantage has waned, you need only lower your price. It is all a matter of adjustment; at some point—which is to say, at some price—the curves of supply and demand will intersect.

Real life is not always so flexible as economic theory would suppose. For instance, wages sometimes stop rising but they rarely decline, because people cannot stand to live under circumstances in which the price of labor fluctuates like the spot price for oil. But there is an even more important exception to the economists' contention that what goes up must eventually come down.

Because of the relentless workings of compound interest—the mathematical formula under which the interest earned in each period is added to the principal sum, so that the interest is larger in the next period than it was in the last—when things start moving in a certain direction, they can gain rather than lose speed. A debtor who has a little trouble meeting this year's interest payments will have a lot of trouble next year. Because compound interest introduces a momentum of its own, trends subject to its influence behave very differently from normal equations of supply and demand. By the time a trend of this kind is detected, it will rapidly be getting worse.

The magic of compound interest is becoming the central explanatory fact about the American economy. In three fundamental and related areas the United States is quite suddenly shifting to the wrong side of the interest curve. Taken one by one, the changes are familiar; taken all together, they tell us something about the economy which we'd rather not know.

The first change is the sudden disappearance of America's surplus in the international balance of trade. During the 1970s the United States managed to sell almost exactly as much to other countries as it bought from them—even though it was unexpectedly obliged to spend astronomical sums for imported oil, and even though foreign competitors had already made deep inroads into traditional American bastions, from radios to steel. The trade deficit for the entire decade of the seventies was $20 billion. Now things have changed so drastically that the deficit for 1985 alone will be more than $120 billion.

To make quickly the point that Walter Mondale made ad nauseam but to no effect in last year's campaign: the sudden collapse of the United States in international trade may have something to do with poor management or shoddy workmanship or unfair trade restrictions, but it mainly has to do with ballooning federal deficits. Because of the deficits, the government needs to borrow more money; because it has borrowed more, real interest rates have gone up; because U.S. interest rates are higher, foreigners are depositing more money in American banks; and because so much foreign money has been coming into the country, the exchange rate for the dollar became and has stayed unreasonably high. By most estimates, the dollar is worth about 40 percent more than its "natural" value against European and Japanese currencies. This is the equivalent of a 40 percent export tax on U.S. products, and it has had predictable results.

As recently as 1980 the merchandise category of U.S. trade accounts—which includes automobiles, shoes, and all the other manufactured goods in which the United States has psychologically conceded defeat—showed a $20 billion *surplus*. By last year that had changed to an $80 billion deficit, a swing of $100 billion in four years. According to Peter Peterson, a former secretary of commerce and a present-day Jeremiah about deficit spending, the decline in exports has cost the United States 2.5 million jobs. Roy E. Moor, of the First National Bank of Chicago, has pointed out that of all the dozens of categories of American industry, only five managed to sell more goods abroad in 1984 than they sold in 1981—and even in those "successful" industries imports grew much faster than exports. The greatest American success stories were in the "business and office machine" category, notably computers. But even there imports grew almost four times faster than exports. Apart from the five successful groups (the others were cars, non-medicinal chemicals, non-food consumer goods, and electrical and electronic products), *all* other categories of American industry exported less in 1984 than they had in 1981. By the middle of 1984 the United States was importing 60 percent more than it was exporting—the most unfavorable ratio in our modern history, and one found more often among developing countries than among major industrial powers.

THE COMPETITIVE position of the United States might theoretically be brighter than the balance-of-payments figures would imply. American companies might conceivably be building efficient new plants overseas, with which they would defend their market share, even though they would not be restoring American jobs. But since American exports have collapsed so suddenly, such long-term investments would be slow to take up the slack—and in fact the flow of investments has been running the opposite way. Rather than sending capital abroad to build new plants and equipment, the United States has started borrowing from other nations, to subsidize its own consumption. This in turn helps explain the second radical change in America's economic position: the virtually instantaneous disappearance of the financial credits the United States had slowly accumulated around the world.

During the nineteenth century, when the United States was expanding its railway network and establishing its industrial base, foreign investors made loans and bought stock to provide much of the necessary capital. Late in the century, when the United States emerged as a pre-eminent industrial and agricultural power, it began to reverse the flow, using its new earnings to make loans and start businesses overseas. By the beginning of the First World War the United States had become a net international creditor for the first time in its history, meaning that the value of its loans and investments in other countries exceeded the value of foreign investments here. For the next sixty-five years its standing as a creditor improved, until in 1982 it enjoyed an international-investment surplus of $150 billion.

Then, in less than three years, everything changed. In the world as economists usually imagine it, the United States could not have gone into debt as rapidly as it in fact has. If the country developed a grievous balance-of-trade problem, the obvious next step would be for the value of the dollar to fall. The Japanese and Germans, having sold their wares to Americans and bought little in return, would find themselves with unwanted surpluses of dollars. When they exchanged them for the yen or Deutschmarks they preferred to have, the pressures of supply and demand would drive down the value of the dollar relative to other currencies. This, in turn, would make imports more expensive in the United States and American exports more attractive. The trade imbalance would be self-correcting.

But that is not what the Japanese and others have done with their dollars. For a variety of reasons—lack of investment opportunities in their own countries, persistently high interest rates in the United States, other factors whose influence economists are now debating—they have deposited their dollars in U.S. banks and bought U.S. bonds, rather than trading the dollars for yen. Several consequences have followed. Japanese VCRs and Italian shoes seem artificially cheap in the United States, since the value of the dollar has been held artificially high. Credit is artificially easy for Americans to obtain, since the Bank of America can use the deposits it has received from Japanese investors to make loans to families that want to buy Japanese cars. When all the complications are boiled away, what's left is a cycle in which the United States started borrowing money from foreigners to buy cut-rate foreign goods—and has kept borrowing and buying at faster and faster rates.

By the end of last year the international debts of the United States had grown so quickly that they had come to equal its investments. And they kept on growing; indeed, because of the workings of compound interest they gathered speed as the United States moved deeper into the debtor category. By the end of this year the United States will stand roughly $100 billion in debt to the rest of the world, which will make it the largest debtor nation, eclipsing the Mexicos and Argentinas—and this less than three years after being the largest creditor. By the end of next year it will owe at least $100 billion more.

One crucial technical measure of the velocity at which a country is moving into debt is the ratio between two financial indicators, the current-account deficit and the exports of goods and services. Roughly speaking, the equivalent measure for a household is the ratio between how much new money it is borrowing each year and how much it earns. In 1982, when the Third World's "debt crisis" was widely publicized and feared, this ratio reached a peak of 24 percent for the major debtors. Peter Peterson points out that in 1984 the United States' ratio rose above 25 percent.

THE THIRD AND most familiar of the economic changes is the phenomenal growth of federal deficits during the past four years. "Deficit spending" has been such a traditional bogey in U.S. politics that it is surprising to realize how modest most previous deficits have been. Before 1980, only twice in America's peacetime history had the annual federal deficit equaled more than three percent of the gross national product. The deficit for 1983, the largest in American history in both relative and absolute terms, equaled 6.4 percent of the GNP. According to most projections, the deficit will remain indefinitely in the five-percent range, unless federal taxing or spending policies change far more dramatically than any politician has yet proposed.

The previous "large" deficits all occurred either during wars or during economic recessions, when tax receipts are unusually low and social-welfare spending is high. These new deficits are much less cyclical. Indeed, the Administration's projections show sustained high deficits despite an assumption that the economy will grow smoothly and uninterruptedly in the future, as it never has grown in the past. Politicians such as Congressmen Jack Kemp and Newt Gingrich, and journalists such as Robert Novak and Robert Bartley, the influential editorial writer for *The Wall Street Journal*, have said that warnings about the deficits are more of the old leftist defeatism. Why concentrate on the bad news, when with the correct, optimistic policies we can grow our way out of the deficit? True, the deficit may shrink if the tonic effects of Reaganomics are so powerful and long-lasting that the American economy moves onto an entirely different plane, like an underdeveloped country reaching "take-off," in W.W. Rostow's famous model. If unemployment goes below four percent and stays there, and if real growth reaches five or six percent a year and stays there, then the nation's greatest concern will be managing its affluence and leisure time. But short of that, the deficit won't "grow" away. The basic mathematics of today's tax and spending policies will leave a chronic gap between what the government takes in and what it pays out.

AS RONALD REAGAN understands, Walter Mondale learned, and the U.S. Congress demonstrates each day, debt and deficits are practically meaningless as political issues. "Nobody has successfully translated the evils of debt and deficits from the abstract to the real," Representative Jim Jones, of Oklahoma, a former chairman of the House Budget Committee, told me this summer. "Once it's shown to be a pocketbook issue, it will be dealt with. But for now it's all downside."

In the White House and Congress early this spring there was a flurry of concern over the deficits. The Administration's pollsters determined that with Mondale safely interred, the public was starting to express worry about the deficits. But once Congress had passed mild anti-deficit measures, which would stop the defense buildup and cut about $50 billion from the 1986 deficit (leaving it at about $170 billion), the issue resumed its accustomed seat in the rear.

The unsexiness of dealing with deficits is hardly surprising. When the workings of compound interest are considered, it becomes obvious why the sudden recent shifts in our economic standing have not yet registered as a national crisis—indeed, have done so much for our recent prosperity—and why they will cause so much harm for so many years to come.

Of the three recent changes, one can be depended on to correct itself, sooner or later. At some point we'll have sent more dollars to Japan than the Japanese care to deposit in American banks or sink into U.S. Treasury bills. Then the value of the dollar will fall, imports will become more expensive, and the trade deficit will be reduced. The main uncertainty is how this will occur. Will the United States carry out its threats to retaliate against the Japanese with protectionist laws? (It may seem quaint now, but in 1971 Richard Nixon's revolutionary package of protectionist measures was provoked by fears of a two-billion-dollar annual trade deficit, or roughly six days' worth at today's pace.) Will foreign investors decide to do us a favor, by shifting their capital to other nations gradually, thereby decreasing demand for the dollar slowly and letting its value drift gently down, in turn making U.S. exports more attractive? Will there instead be a panicked run on the dollar, suddenly disrupting certain industries and reintroducing us to our old nemesis, inflation?

Whenever and however the inevitable adjustment occurs, the years of grotesque trade deficits will have done some damage, perhaps even of the "irreversible" variety. How much goodwill and market position will the Caterpillars and IBMs have sacrificed? And will other countries be so thoroughly accustomed to our insatiable demand for imports as to have difficulty in adjusting to its disappearance? Bankers and economists point out that for the past four years the U.S. trade deficit has been a powerful, if imprecisely directed, anti-poverty weapon. Our imports are everyone else's exports, so the booming demand here has given developing countries (along with Japan and Europe) a chance to sell their wares. All we have asked in return is that they lend us the money with which to make the purchases. By creating a debt crisis of its own the United States has helped other countries solve theirs.

While the adjustment may be rocky and the damage to U.S. exporters profound, the trend of the trade imbalance has to be toward correction. It is hard to be so confident, if that is the word, about what will become of the country's newly accumulated foreign debts and federal deficits.

From the beginning of the First World War to 1982 the position of the United States as an international creditor generated a steady stream of dividends and profits for U.S. investors. Money deposited in English banks caused interest payments to be sent back to the United States. Investments that helped build oil wells in Indonesia or computer factories in France or clothing works in Taiwan came back to America as profits. Some of the money was taxed away and used by our government; some was reinvested at home or abroad; some was spent on goods from cars to caviar; some may have been stashed in Swiss bank accounts, which pay little or no interest but offer the comfort of anonymity, or simply squandered. Whatever its precise disposition, all of it was money that the nation did not have to generate by other means. Taxes were lower, government benefits more generous, the standard of living higher than would otherwise have been the case. Whenever the United States had trouble exporting merchandise, the profits and dividends streaming back from overseas helped the nation pay for the imports it desired.

Now the situation is exactly the reverse. The $300 billion in foreign loans that have come into the country in the past three years have given us Hondas and Beaujolais we could not otherwise have afforded and (to the extent that foreigners have lent money to cover the federal deficit) government benefits for which we would otherwise have had to tax ourselves. In exchange for these three years of subsidized consumption we have obligated ourselves to send profits and dividends the other way from now on. Whatever benefit our six decades of foreign investment represented, our rapidly growing foreign debt now constitutes an equivalent handicap.

The increase in federal indebtedness arises from the same exchange—subsidized consumption now, in return for a lower standard of living in the future—but is on an even grander scale. During the Second World War the United States took on an enormous debt, in the attempt to defeat Hitler and Tojo. But for the next thirty-five years federal debt gradually declined relative to the rest of the American economy. That trend reversed itself with the coming of the Reagan Administration, and because of what has happened from 1981 to 1985, the United States for the indefinite future will see its freedom of action reduced. Because of just these four years of debt, Ronald Reagan's successors will find it hard to do anything other than meet the government's interest obligations, and the nation as a whole will have more difficulty investing in education, technology, or other sources of happiness and wealth.

In 1980 one dollar of each ten the federal government spent was to pay interest on the national debt. Now interest consumes one dollar of each seven. To put it another way, nearly four dollars of each ten the government collects in individual income taxes goes not for Trident submarines or National Park rangers or even for Social Security benefits but for the premiums on Treasury bills. As interest payments continue to rise, the government must collect more in taxes, reduce its other functions, or borrow more money—and borrowing more of course means that interest payments will rise even faster the following year.

As the House Budget Committee summarized the situation, in a report last May:

> The rising interest burden makes the distribution of income more unequal; it will eventually lead to higher taxes which may affect economic efficiency; and it means less room in the budget for Federal programs which meet genuine national security, investment, or social needs, rather than just servicing debt.

Already the federal budget is showing signs of being squeezed by interest payments—and, of course, by defense and Social Security. Ronald Reagan continues to talk as if he were holding the line on spending for everything except defense, but in fact his legacy will be to have presided over large increases in interest payments, Social Security, and Medicare, in addition to defense. (Defense spending has risen from 5.8 percent of the GNP in 1975 to 6.5 percent now, on its way to the Administration's goal of 7.8 percent in 1990. Social Security and Medicare have risen from 5.2 percent in 1975 to 6.6 percent now.) The radical reductions have come only in the small part of the budget left over after these big-ticket accounts have been funded. Even though federal spending, as a proportion of the GNP, is higher under Ronald Reagan than it has been under any other President except Franklin Delano Roosevelt in wartime, spending for everything except interest, Social Security plus Medicare, and defense has shrunk. In 1975 this "other" category of federal spending accounted for 11.1 percent of the GNP; it is now 9.3 percent and according to the Administration's projections should fall to 6.0 percent by 1990.

Some conservatives claim that a hidden virtue of deficits is precisely that they starve the government and thereby keep the liberals from dreaming up any crazy new ways to waste money. Twenty years ago politicians were arguing about which programs to expand; now everyone argues about where to cut. If the deficits ever shrank, the conservatives say, those irrepressible liberals would be trying to start programs again.

Useful as it may be for the conservatives at this moment, this endorsement of deficits does seem shortsighted, both for their own political interests (what greater enemy do the defense budget and lower taxes have than the deficit?) and for the nation's ability to compete economically. Far beyond the effect that the government deficit has on the federal budget, it is beginning to encroach on the entire society's ability to invest in its future. One measure of how much capital is available for productive investment is the U.S. "net savings rate"—private savings, minus depreciation, plus surpluses generated by state and local governments. Since 1960 this measure has held remarkably constant, at about eight percent of the GNP. But after the demands of the federal deficit have been satisfied, there has been less and less capital left for other purposes. For the period 1961 to 1970, 7.4 percent of the GNP, or better than 90 percent of net savings, was available for investment and capital formation, after covering the deficit. From 1981 to 1984, 2.7 percent, or about a third of net savings, was. Federal deficits now consume two thirds of the nation's net savings. Only one third is available for investment in future growth.

Many types of federal spending, of course, result in what should be considered productive investments—highways, schools, hospitals, agricultural-research stations, and even space missions are obvious examples. The public debt might be less worrisome if its growth could be explained by projects like these, which can in various ways eventually help cover their own costs. But today the government is spending and borrowing much more but investing less. The only increases in government spending have been for interest, retirement, and the military. (Caspar Weinberger often claims that defense spending is "productive," since it creates jobs, technical spin-offs, and so forth, but few economists take this idea seriously. Almost any other type of spending creates more jobs. And money devoted to commercial research and development is more likely to produce usable technical innovations—otherwise, how would the Japanese, with virtually no military establishment, have stayed in the technical race?)

FEW EXPERTS PRETEND to understand fully the forces that have kept the dollar rising in value even as U.S. exports have fallen, thereby aggravating the accumulation of debt and confounding the underlying logic of economics. Still, it's hard not to conclude that something fundamental has changed in the U.S. economy in the past four years—namely, the assumption about how, and whether, we will pay our way.

As the President and his representatives have often emphasized, the United States has enjoyed a kind of economic renaissance in the past two years. After the severe recession of 1982 the United States began creating new jobs and generating new opportunities at a tremendous clip. Income is up; inflation is down; the Europeans are mad with envy. The bath of resultant good feelings helps explain the President's overwhelming re-election a year ago.

Part of the credit for the economic recovery must go to changes that the Reagan Administration deliberately made. Everyone likes lower taxes. Those intangible but undeniable feelings of confidence and optimism have increased. Still, a look at the balance sheets suggests a more obvious explanation for America's feeling good about itself. Why shouldn't we feel good, when we're paying only eighty cents for every dollar of government benefits we receive? What's not to like, when we can buy a dollar's worth of imports with exports worth sixty cents? Everyone feels optimistic on an expense account—and everyone is ready to believe that he deserves every comfort he's been offered, and then some. The genius of Ronald Reagan has been to play to these natural vanities, helping us believe that what looks very much like a subsidy is in fact proof that we are standing tall. Such is the emerging idea of "service" under President Reagan (they also serve who only stand and spend). We will bear any burden, except those that are inconvenient. We will do whatever it takes to re-arm the United States—except draft the soldiers or raise taxes to pay for the weapons. We will do all that's necessary to rebuild the American economy, by getting used to being subsidized.

If we could count on the boom to last forever—if other nations would subsidize us indefinitely in order to create a market for their goods—we'd have no source of discomfort except dreary puritanical reminders that we had turned into freeloaders. Or if we were sure we could readjust to the old ways whenever the boom came to an end, then even as we paid the bills we could think back fondly to a free ride that lasted a few years. But given the ratchet effect of democratic politics—it's much harder to give something up than to keep doing without something you never had in the first place—how can we ever go back to the old days? Given the humiliation of Walter Mondale, how many politicians will run on a platform calling for higher taxes?

The House of Representatives—like the Senate, and like President Reagan—has not made any significant dent in the deficits. But the House Budget Committee at least made clear in its report on deficit spending that the ultimate cost of chronic deficits was "the way citizens view their government":

> In the short term, [Americans] may find it an attractive "bargain" to receive $100 in national defense and government services for only $80 in taxes, as at present. In the longer term they will react in anger and disappointment when they find the deficit must be paid for, after all, with higher taxes and inflation. As this process proceeds, confidence in government and the competence of fiscal management will erode, further weakening the political institutions of our society. That may be the final and most costly burden placed on future generations.

Ronald Reagan's supporters contend that his Administration has restored confidence and patriotism to a nation that lacked them. Maybe so; but it may be remembered longer for conditioning us to the free lunch.

—James Fallows

LANGUAGE

THE IRISH QUESTION

Declining as a native tongue, Gaelic is expanding as an acquired one. The ancient language lingers on

WHEN I WAS A schoolboy in Ireland, some years ago, my classmates and I would slip copybooks up the sleeves of our uniform jackets before the nine-thirty class taught by Mr. Doyle. The copybooks were soft enough to fit snugly around the upper arm but also stiff enough to afford the deltoids a measure of protection.

The subject that Mr. Doyle taught was the most unpopular one in the school—the Irish language, sometimes called Gaelic—and the resistance it met would have tried the patience of men with milder temperaments. The class was conducted entirely in Irish, and Mr. Doyle would pounce angrily upon laggards who had failed to prepare for the day's lesson. His verbal upbraidings concluded with a stirring finale. "*An dtuigeann tú?*" Punch. "*An dtuigeann?*" Punch. "*An dtuigeann?*" ("*An dtuigeann tú?*" means "Do you understand?") Eventually Mr. Doyle would desist and accept a meek, propitiatory "Okay, *tuigim, tuigim*" from the quaking malefactor. I think he knew all along about the copybooks up our sleeves, but it was important to him that pain, like respect for the Irish language, at least be feigned.

This was during the mid-1960s, four decades after the Dublin government, newly independent, had launched an aggressive campaign, largely centered on the schools, to restore Ireland's moribund national tongue to its "rightful place" among the living languages of the world. The Irish language, schoolchildren like me were told, was a precious and essential part of the nation's heritage, one that not even centuries of oppression had been able to eradicate. It was a sublime and glorious tongue. ("Never forget, lads, that Ireland gave Europe its first vernacular literature.") To be sure, turning a land of English-speakers into a land of Irish-speakers more than a century after Irish had ceased to be the majority language would be a formidable task. But other, "lesser" languages had managed to survive and even prosper under circumstances almost as severe. ("Look at Quebec! Look at Israel!") Besides, if the language were lost, then what would Ireland have left? How, in any fundamental sense, would Ireland remain distinct from England? ("We'd still be Catholics, yes, but look into your hearts, *a bhuachaillí*—do you see the faith growing stronger there day by day?") The battle, in short, was one for the nation's soul.

It was clear twenty years ago, however, that the ambitious effort to revive the Irish language was falling short of its objective. To be sure, the physical evidence of Irish abounded. Street signs and official documents were (and are) bilingual. There were Irish-language programs on Telefís Éireann and Radio Éireann. Politicians as a matter of course began their speeches with a bit of Gaelic boilerplate. At school, instruction in the language was mandatory, and a demonstrated proficiency in Irish served (by law) as an entry-level shibboleth for higher education and a good many jobs. People went along. Yet I recall little enthusiasm for the Irish language among either my contemporaries or their parents, and I knew of no one who used Irish at home. Outside of school, or once employed, there was usually no reason for a person to speak Irish, no stigma or discomfort in letting the language lie fallow. One did not need Irish to transact business with the victualler or to ask directions from the bus driver. When the Vatican ordained that the Mass be said in the vernacular, the vernacular of choice in Ireland was English. "The Fugitive" and other television shows that people actually watched were broadcast in English. Debates in the *Dáil* (Parliament) were, and are, conducted in the native tongue of John Bull.

Some people, of course, were ardent language advocates, and thanks to Ire-

REMARKS OF WILLIAM J. CASEY

DIRECTOR OF CENTRAL INTELLIGENCE

BEFORE THE

DALLAS COUNCIL ON WORLD AFFAIRS

HYATT REGENCY HOTEL
DALLAS, TEXAS

WEDNESDAY, 18 SEPTEMBER 1985
11:30 A.M.